ISSUE DATE: September 30, 1998

DOCKET NO. G-002/GR-97-1606

FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

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BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Edward A. Garvey	Chair
Joel Jacobs	Commissioner
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In the Matter of the Application of Northern States Power Company's Gas Utility to Change its Schedule of Gas Rates for Retail Customers Within the State of Minnesota

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FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

PROCEDURAL HISTORY

On December 2, 1998, Northern States Power Company's Gas Utility (NSP Gas or the Company) filed a petition seeking a rate increase of $18.504 million or approximately 5.1 percent over existing rates, based on a 1998 forecast year. In addition, the Company proposed several changes to the provisions of its Minnesota Gas Rate Book to revise the terms and conditions of various existing rate schedules and to offer certain new services. The Petition included the prefiled testimony of various witnesses for the Company, and required filing statements under the Commission rules, constituting the Company's case in chief in support of the proposed rate and tariff changes. The Company also filed a Petition for Interim Rates requesting an interim rate increase of $15.603 million or 4.6 percent.

On December 8,1997, December 12,1997, and December 23,1997, NSP Gas filed certain supplemental errata data to the Petition. No party objected to the inclusion of the supplemental information in the record.

On January 14,1998, the Commission issued an ORDER ACCEPTING FILING AND SUSPENDING RATES, AND A NOTICE AND ORDER FOR HEARING referring the case to the Office of Administrative Hearings (OAH) for contested case hearings. Administrative Law Judge Richard C. Luis (Presiding Judge) was assigned by the OAH to preside over the contested case hearings.

On January 30,1998, the Commission issued its ORDER ESTABLISHING INTERIM RATES authorizing NSP Gas to collect $13.928 million annually in interim rates, an increase of 4.11 percent, subject to refund and the outcome of the contested case proceedings.

On February 4,1998, the Administrative Law Judge held a Prehearing Conference and issued a Prehearing Order on February 20,1998. The Administrative Law Judge's Order granted petitions to intervene of the Minnesota Department of Public Service (the Department), the Residential and Small Business Division of the Office of the Attorney General (RUD-OAG), and Duke Energy Services, Inc. (Duke). In addition, Northern Natural Gas Company, division of Enron Corp. (Northern), and PAM Natural Gas Inc. (PAM) filed uncontested motions to intervene within the time set for interventions in the Administrative Law Judge's Prehearing Order.

On March 26 1998, the Department and RUD-OAG filed intervener testimony.
On April 13, 1998, the Department filed revised direct testimony of Vincent C. Chavez on one

issue (the Viking amortization cost recovery issue) to resolve certain concerns related to proprietary data contained in the Department's March 26,1998 pre-filed direct testimony.

On April 24,1998, NSP Gas filed rebuttal testimony to the Department and RUD-OAG's direct testimony and the Department and RUD-OAG filed surrebuttal testimony on May 6,1998.'

On May 5,1998, NSP Gas and the Department filed an Offer of Partial Settlement on Rate Design and Revenue Apportionment (Rate Design Settlement), which addressed the vast majority of rate design and class cost allocation issues.

On May 21,1998, NSP Gas, the Department and the RUD-OAG filed a Revenue Requirements Stipulation and Offer of Partial Settlement ("Revenue Requirements Settlement") to resolve the vast majority of remaining revenue requirements, rate base and income statement issues.

On June 17,1998, NSP Gas and the Department filed initial briefs.

On June 19, 1998, NSP Gas, the Department and OAG-RUD filed a Revised/Annotated Revenue Requirements Stipulation and Offer of Partial Settlement (Revised Settlement), as requested by the Administrative Law Judge. The Revised Settlement did not change the terms and conditions of the Revenue Requirements Settlement, but provided more detailed annotations to the record support for each component of the Revenue Requirements Settlement.

On July 2,1998, NSP Gas and the Department filed Reply Briefs and Proposed Findings of Fact and Conclusions of Law. The record in this matter closed on that date.

I. PARTIES AND REPRESENTATIVES

A. Intervenors

The intervenors and their representatives in this matter are as follows:

The Minnesota Department of Public Service (the Department) represented by Gregory P. Huwe and Julia E. Anderson, 1200 NCL Tower, St. Paul, Minnesota 55101.

The Residential and Small Business Utilities Division of the Office of the Attorney General (RUD-OAG) represented by Joshua S. Wirtschafter.

Duke Energy Trading & Marketing, L.L.C. represented by Gordon J. Smith, John & Hengerer, 1200 17th Street, N.W., Suite 600, Washington, D.C. 20036 and Kris Errickson, One Westchase Center, 10777 Westheimer Street, Suite 650, Houston, TX 77042.

Pam Natural Gas represented by Jennifer Erickson, P.O. Box 5200, Sioux Falls, SD 57117-5200.

Northern Natural Gas (Northern), a Division of ENRON, Corp. represented by James R. Talcott, P.O. Box 3330, Omaha, NE 68103-0330.

B. The Company

Northern States Power Company's Gas Utility was represented by James P. Johnson, 414 Nicollet Mall, Minneapolis, MN 55401 and Samuel L. Hanson, Briggs & Morgan, 2400 IDS Center, Minneapolis, MN 55402.

II. PUBLIC HEARINGS AND PUBLIC TESTIMONY

The Administrative Law Judge held public hearings to receive the comments and questions of affected customers as follows:

April 13 (afternoon) -- St. Paul;
April 13 (evening) - White Bear Lake;
April 16 (evening) -- St. Cloud.

A total of sixty four (64) persons attended the public hearings and seven (7) members of the public spoke for the record. Actions recommended by the speakers included the following:

- withholding any rate increase until after completion of and assessment of savings from the planned Viking Voyageur project[1];
- providing a return on equity (specifically, 11.88%) deemed to be equitable and fair for shareholders;
- emphasizing the development of more renewable, sustainable resources rather than non-renewable energy sources such as natural gas and nuclear fission;
- keeping rate increases down to assist homeowners, retirees, and low-income persons;
- providing a rate break for low-income persons or persons using low volumes of gas;
- having annual rate increases rather than allowing a larger increase every few years; and
- providing an adequate explanation of the "Resource Adjustment" line on the bill.

The letters from the public raised concerns similar to those in the oral testimony. One letter raised a concern about the proposal to raise residential rates by a greater percentage than business rates.

III. EVIDENTIARY HEARINGS

On May 12,1998., the evidentiary hearings commenced at the Commission's Large Hearing Room in St. Paul, Minnesota. After the cross-examination of Mr. James H. Wilson for the Company, the Administrative Law Judge continued the evidentiary hearings until May 21,1998, to allow the parties an opportunity to resolve as many of the remaining issues as possible by stipulation or settlement.

On May 21,1998, NSP Gas, the Department and the RUD-OAG filed a Revenue Requirements Stipulation and Offer of Partial Settlement ("Revenue Requirements Settlement") to resolve the vast majority of remaining revenue requirements, rate base and income statement issues.

The evidentiary hearings then reconvened on May 21,1998 for the remaining disputed issues, and concluded on May 22,1998.

IV. PROCEEDINGS BEFORE THE COMMISSION

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[1] NSP withdrew from the proposed Viking Voyageur project subsequent to filing its rate case petition.

On July 30, 1998, the Administrative Law Judge filed his *Findings of Fact, Conclusions and Recommended Order*. Among other things, the Administrative Law Judge recommended that the Commission

- approve the Revenue Requirements Settlement and the Rate Design Settlement pursuant to Minn. Stat. § 216B.16, subd. 1a;

- reject the Company's proposal to change its customer bill format;

- accept the Company's proposals to establish an Attribution Policy on its Conservation Improvement Program (CIP) Factor Adjustment Tariff and to exclude Conservation Cost Recovery Charge (CCRC) and CIP Factor Adjustments from Negotiated Transportation Service Rates;

- reject the Company's proposals to allocate test year CIP costs among NSP Gas customer classes based on the demand and energy allocation and to include the CCRC in the Distribution Charge for customers with flexible rate provisions.

On August 13, 1998, NSP Gas filed exceptions to the Administrative Law Judge's Report.

On September 1, 1998, the Commission met to hear oral argument from the parties. The Commission met to deliberate this matter on September 3, 1998.

Upon review of the entire record of this proceeding, the Commission makes the following Findings, Conclusions, and Order.

FINDINGS AND CONCLUSIONS

V. JURISDICTION

The Commission has general jurisdiction over the Company under Minn. Stat. §§ 216B.01 and 216B.02 (1996). The Commission has specific jurisdiction over rate changes under Minn. Stat. § 216B.16 (1996).

The case was properly referred to the Office of Administrative Hearings under Minn. Stat. §§ 14.48-14.62 (1992) and Minn. Rules, part 1400.0200 et seq.

VI. FURTHER ADMINISTRATIVE REVIEW

Under Minn. Rules, part 7830.4100, any petition for rehearing, reconsideration, or other post-decision relief must be filed within 20 days of the date of the Order. Such petitions must be filed with the Executive Secretary of the Commission, must specifically set forth the grounds relied upon and errors claimed, and must be served on all the parties. The filing should include an original, 13 copies, and proof of service on all parties.

Adverse parties have ten days from the date of service of the petition to file answers. Answers must be filed with the Executive Secretary of the Commission and must include an original, 13 copies, and proof of service on all parties. Replies are not permitted.

The Commission, in its discretion, may grant oral argument on the petition or decide the petition without oral argument.

Under Minn. Stat. § 216B.27, subd. 3 (1996), no Order of the Commission shall become effective while a petition for rehearing is pending or until either of the following: ten days after the petition for rehearing is denied or ten days after the Commission has announced its final determination on rehearing, unless the Commission otherwise orders.

Any petition for rehearing not granted within 60 days of filing is deemed denied. Minn. Stat. § 216B.27, subd. 4 (1996).

VII. THE COMPANY

NSP's gas utility serves as a local distribution company providing retail gas service to approximately 344,000 customers in Minnesota. Most of its customers are located in the "metro east region," which is comprised of the City of St. Paul and suburbs to the east, north and south of that City. In addition, the Company serves customers in the St. Cloud/ Sauk Rapids area, the Northfield and Faribault areas, the East Grand Forks area, the Moorhead area, and communities such as Red Wing, Wabasha, and Winona.

NSP's gas utility has 422 employees. It also receives support from NSP's corporate operations and the Company's electric utility.

VIII. BURDEN OF PROOF

Minn. Stat. § 216B.16, subd. 4 (1996) states: "The burden of proof to show that the rate change is just and reasonable shall be upon the public utility seeking the change."

The Minnesota Supreme Court has articulated standards for the burden of proof in rate cases. In the Matter of the Petition of Northern States Power Company for Authority to Change Its Schedule of Rates for Electric Service in Minnesota, 416 N.W. 2d 719 (Minn. 1987). In the Northern States Power case the Court divided the ratemaking function of the Commission into quasi-judicial and legislative aspects. The Commission acts in a quasi-judicial mode when it determines the validity of facts presented. Just as in a civil case, the burden of proof is on the utility to prove the facts by a fair preponderance of the evidence. Such items as claimed costs or other financial data are facts which the utility must prove by a fair preponderance of the evidence.

The Commission acts in a legislative mode when it weighs the facts presented and determines if proposed rates are just and reasonable. Acting legislatively, the Commission draws inferences and conclusions from proven facts to determine if the conclusion sought by the utility is justified. The Commission weighs the facts in light of its statutory responsibility to enforce the state's public policy that retail consumers of utility services shall be furnished such services at reasonable rates. In its legislative capacity, the Commission forms determinations such as the usefulness of a claimed item, the prudence of company decisions, and the overall reasonableness of proposed rates.

The utility therefore faces a two part burden of proof in a rate case. When presenting its case in the rate change proceeding, the utility has the burden to prove its facts by a fair preponderance of the evidence. The utility also has the burden to prove, by means of a process in which the Commission uses its judgment to draw inferences and conclusions from proven facts, that the proposed rates are just and reasonable.

IX. TEST YEAR

The Company proposed the twelve-month period from January 1, 1998 through December 31, 1998 as its test year in this proceeding. The test year data was fully projected, based on the

Company's budgeting process. The Administrative Law Judge found that this was the appropriate test year for determining the Company's revenue deficiency. (Administrative Law Judge's Conclusion #4, page 21.)

The Commission agrees with the Administrative Law Judge that the Company's proposed test year is appropriate. The Commission accepts the Company's proposed test year for purposes of this general rate case.

X. REVENUE REQUIREMENTS STIPULATION AND OFFER OF PARTIAL SETTLEMENT

All parties who filed testimony on financial issues (the Company, the Department, and the RUD-OAG) signed and filed a stipulation and offer of partial settlement resolving nearly all of the revenue requirements, rate base, and income statement issues in the case.[2] At the request of the Administrative Law Judge, they later filed an annotated version of the document detailing the record support for their proposed resolution of each settled issue. Neither document was opposed by any party.

The Administrative Law Judge found that the stipulation and offer of partial settlement were supported by substantial evidence, served the public interest, and met the statutory standard. The Commission agrees.

A. Stipulated and Settled Issues

The stipulation and offer of partial settlement contained both stipulated and settled issues, separately labeled and separately treated. In this context stipulations and settlements have different purposes and functions and must be treated differently.

The stipulated portion of the agreement presents discrete factual and policy issues which have been resolved independently of one another. They are not presented as a package or as the product of compromise. The stipulated resolution of any individual issue does not depend upon the stipulated resolution of any other issue or upon accepting the stipulation as a package.

The effect of the stipulated portion of the agreement is the same as the effect of the parties individually taking the same position on the stipulated issues. The parties have simply formalized their agreement and offered their consensus as evidence of the reasonableness of their positions. For these reasons, the Commission may accept the parties' resolution of some of the stipulated issues without accepting their resolution of others, and it may do so without giving the parties a chance to change their positions.

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[2] A copy of the stipulation and offer of partial settlement is attached. Only one issue was unresolved -- the recoverability of the portion of the corporate officers' incentive compensation package which was linked to the Company's financial performance.

The settlement portion of the agreement, on the other hand, is offered as a package and as the product of compromise. Settlements are encouraged under Minn. Stat. § 216B.16, subd. 1a, which requires the Commission to consider and deal with them as a package. The statute recognizes that a settlement is an integrated whole whose individual provisions are mutually dependent and may be linked in ways that are not immediately apparent. Therefore, the statute gives any settling party the right to reject any modification the Commission makes to a settlement and to return to hearing.

B. The Stipulated Issues

Four issues or clusters of issues were resolved by stipulation as undisputed. They are listed in the stipulation and offer of settlement as follows: 3.1. Capital Structure/Cost of Capital; 3.2. Depreciation Adjustment; 3.3. Miscellaneous Rate Base Adjustments; and 3.4. Miscellaneous Income Statement Adjustments. For the most part these are issues on which parties shifted their positions early in the evidentiary proceedings.

In the stipulation the parties cited record support for their position on each issue. At hearing they made their witnesses available for questioning by the Administrative Law Judge and Commission staff.

The Commission has examined the record and the stipulation on each issue and finds that the parties' positions on these issues are reasonable, are supported by substantial evidence, are in the public interest, and will lead to just and reasonable rates. The stipulated resolutions will be accepted and adopted.

C. The Settled Issues

The legal standard for evaluating settlements is set forth in Minn. Stat. § 216B.16, subd. 1a(b):

> The Commission may accept the settlement on finding that to do so is in the public interest and is supported by substantial evidence.

The Administrative Law Judge examined the settlement, and each issue settled, for reasonableness and support in the record. He found that the settlement was supported by substantial evidence and that accepting it would be in the public interest. He recommended accepting it without modification.

The parties thoroughly supported their resolution of each issue in the settlement with specific reference to the record. The parties thus demonstrated that the facts in the record were central to their negotiations on every issue. The Company and the Department also made their witnesses available for questioning by the Administrative Law Judge and Commission Staff, to support and clarify, if necessary, the evidentiary basis of all settled issues.

After carefully considering the record on the issues included in the offer of partial settlement, the Commission finds that the parties have supported their positions and grounded their resolutions in the facts. The Commission finds that the settlement is supported by substantial evidence, represents a just and reasonable resolution of the individual issues settled, promotes the public interest, and will result in just and reasonable rates. The Commission accepts and adopts the settlement section of the revenue requirements stipulation and offer of partial settlement.

XI. RATE DESIGN OFFER OF PARTIAL SETTLEMENT

Both parties who litigated rate design issues, the Company and the Department, signed and filed a Rate Design Offer of Partial Settlement resolving nearly all of the rate design, cost allocation, and revenue apportionment issues in the case.[3] The offer of partial settlement was not opposed by any party. As with the revenue requirements stipulation and settlement, the parties supplied support from the record for their resolution of every issue, and they made their witnesses available for questioning by the Administrative Law Judge and Commission Staff.

The Administrative Law Judge found that the offer of partial settlement was supported by substantial evidence, served the public interest, and met the statutory standard.

The Commission has examined the rate design offer of settlement, and every issue settled, in light of the record and of the standards set forth in Minn. Stat. § 216B.16, subd.1a(b). The Commission finds that the settlement is supported by substantial evidence, represents a just and reasonable resolution of the individual issues settled, promotes the public interest, and will result in just and reasonable rates. The Commission accepts and adopts the rate design offer of partial settlement.

XII. REMAINING CONTESTED FINANCIAL ISSUE

The only contested financial issue was whether the Company should be allowed to recover in rates the portion of corporate officers' salaries ($203,405) that was linked to the price and earnings of the Company's stock.

A. Positions of the Parties

1. The Department of Public Service

The Department opposed linking any portion of incentive compensation to stock performance as inconsistent with Commission action in other cases, pointing especially to the final Order in the 1995 Minnegasco rate case.[4]

The Department also argued that ratepayers, who do not directly benefit from higher stock prices and higher earnings per share, should not bear the cost of producing these benefits for shareholders. Finally, the Department cautioned that shareholders' and ratepayers' interests often conflict and that incentive compensation plans targeting stock performance tend to encourage utility managers to resolve such conflicts in favor of shareholders.

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[3] A copy of the Rate Design Offer of Partial Settlement is attached. Only five issues were unresolved — four interrelated issues on the allocation and recovery of Conservation Improvement Program costs and the Company's proposal to make changes in the format of its customer bills.

[4] In the Matter of the Application of Minnegasco, a Division of NorAm Energy Corp., for Authority to Increase Its Natural Gas Rates in Minnesota, Docket No. G-008/GR-95-700, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (June 10, 1996).

2. The Company

As long as overall compensation levels are within reasonable limits, the Company argued, the Commission should not concern itself with the details of compensation packages. Such concern can only lead to micro-management.

The Company emphasized that the Commission's main concern in its last rate case had been overall compensation levels, not individual compensation formulas. The Company also argued that it would be anomalous to disallow recovery of any portion of incentive compensation, since it was increased reliance on incentive compensation that had allowed it to reduce labor costs below the levels the Commission had found excessive in its last rate case.

The Company claimed its incentive compensation plan struck the proper balance between ratepayers' and shareholders' interests. It pointed out that most of the performance indicators throughout the plan, and all of the performance indicators for employees other than corporate officers, turned on safety, efficiency, customer satisfaction, and other factors that directly benefit ratepayers. Finally, the Company argued that strong financial performance by the Company benefitted ratepayers in the form of lower capital costs, which translated into lower rates.

B. The Administrative Law Judge's Findings and Recommendation

The Administrative Law Judge recommended permitting recovery of all incentive compensation costs, including those linked to stock price and earnings. He said that total compensation amounts were at market levels and that, had the Company proposed to distribute all compensation as straight salary, rate recovery would not have been at issue. In his view, disallowing these costs could result in inconsistent ratemaking treatment of similar levels of test year costs.

He found that the officers' incentive compensation plan appropriately balanced officers' duties to shareholders and ratepayers and provided appropriate incentives for them to balance the obligations and needs of customers, shareholders, and employees.

He, too, found that the Commission's major concern in the last rate case had been excessive overall compensation costs, which the Company had reduced largely through increased reliance on incentive compensation.

C. Commission Action

1. Summary of Commission Findings

The Commission will disallow recovery of incentive compensation amounts linked to the Company's stock price or earnings per share because it is not just and reasonable to assess the costs of increasing Company earnings to ratepayers. The Commission does not read its 1992 NSP-Gas rate case decision as diluting earlier or subsequent decisions disfavoring rate recovery in such cases. The fact that the Company's overall compensation levels are within acceptable limits does not guarantee rate recovery.

2. Rate Recovery Not Just and Reasonable

To qualify for rate recovery, expenses must be reasonable, prudent, and incurred for purposes necessary to the provision of utility service. The costs at issue fail this test.

Maximizing shareholder profits is not necessary to the provision of utility service. As long as the

Company has the fundamental financial strength to maintain the infrastructure, retain competent employees, secure gas supplies, and attract capital at reasonable rates, its ability to provide service is not affected by minor fluctuations in stock performance. Safety and reliability do not rise or fall with the market. Ratepayers do not benefit by locking the attention of officers, and those who report to them, on stock performance.

For shareholders, of course, matters are different. They are affected by every fluctuation in stock value or earnings per share, and the contested portion of the plan is designed to heighten corporate officers' attention to such fluctuations.[5] That is the shareholders' prerogative. The link between those fluctuations and the provision of utility service, however, is not sufficiently clear or direct to justify assessing the costs of the plan to the ratepayers.[6] The contested costs, then, fail the "necessary to the provision of utility service" test.

They also fail the reasonableness test. It is important not to lose sight of the fact that shareholders and ratepayers often have competing, if not conflicting, interests. What shareholders view as efficient cost cutting, for example, ratepayers may view as deterioration in service quality. Corporate officers must balance these competing interests to operate the Company. Tying their salaries to stock performance can only help tilt that balance toward shareholders, to the potential detriment of ratepayers.

Finally, the interests of corporate officers are naturally aligned more closely with shareholders than with ratepayers. They are employed by the shareholders, have a legal duty of loyalty to the shareholders, and are shareholders themselves. There is nothing in the record to suggest that they need additional incentives to give shareholders' interests careful and just consideration.
There is no reason to conclude that, without additional incentives, they will neglect shareholders' interests to the point of jeopardizing the provision of "adequate and reliable service at reasonable rates."[7] As long as this is true, there is no justification for shifting the costs of this program from shareholders to ratepayers.

3. Commission Precedent

The Department correctly notes that the Commission has long opposed linking the salaries of corporate officers, executives, or other employees to the performance of a utility's stock. The Minnegasco case cited by the Department provides a helpful overview of Commission decisions on the issue.

Today's decision to disallow recovery of the contested costs is consistent with past decisions on

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[5] At hearing a Company witness testified, "One of the goals of the [Long Term Incentive Plan] is to align key employees' long term interests with those of NSP's shareholders through the use of stock ownership and long term financial performance goals." Exhibit 9 at 16; Tr.Vol. 2 at 42-43 (Paulson).

[6] While the Company correctly points out that high stock values and high earnings per share can be factors in reducing the cost of capital, they can also be factors in raising utility rates. In both cases, there are too many factors at work to attribute the end result to stock values and earnings per share alone.

[7] Minn. Stat. § 216B.01, the service standard the Commission is charged with ensuring.

the same and similar issues.

4. NSP's Last Rate Case

The Commission does not read the Company's 1992 rate case Orders as supporting the claim that as long as total compensation levels are reasonable, compensation formulas merit little review. The initial ratemaking Order, after all, expressed disapproval of earnings-per-share incentive compensation in the strongest terms:

> The Commission continues to consider earnings per share thresholds an improper transfer of risk, since ratepayers bear the risks (the costs of incentive compensation) and shareholders reap the benefits (increased earnings per share).
>
> The Commission also continues to believe earnings per share thresholds can jeopardize a utility's commitment to providing safe, reliable, economical service over the long-term by over-emphasizing short-term performance. In most private business contexts, short-term thinking is merely unfortunate. In the public utility context, it can create a public crisis.
>
> Another defect in the plan is the large percentage (up to 30% and 40%) of executives' and officers' pay which can come from incentive compensation. These percentages are simply too high. Their stated purpose is to align officers' and executives' interests more closely with those of shareholders. While officers and executives clearly have a duty of loyalty to shareholders, they also have a duty to exercise independent judgment on behalf of the Company and to give regulators their full cooperation. Offering key decisionmakers large financial rewards for producing short-term shareholder benefits does not promote regulatory efficiency or the long-term fortunes of the Company
>
> <u>In the Matter of Petition of Northern States Power Company's Gas Utility for Authority to Change Its Schedule of Gas Rates for Retail Customers Within the State of Minnesota</u>, Docket No. G-002/GR-92-1186, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (September 1, 1993), at 20-21.

After reconsideration, the Commission concluded it could permit rate recovery of some parts of the Company's incentive compensation program. It continued to disapprove of making corporate officers and executives too dependent upon incentive compensation, however -- even traditional incentive compensation not linked to stock performance. The Order After Reconsideration limited rate recovery of "traditional" incentive compensation to 15% of an individual's base salary. It took no action on the "earnings-per-share" portion of the plan, upon being assured that it would not be activated during the test year and would not be ratepayer-funded. <u>NSP</u>, Docket No. G-002/GR-92-1186, ORDER AFTER RECONSIDERATION (December 30, 1993).

For these reasons, the Commission does not read the 1992 rate case Orders as diminishing previously or subsequently stated concerns about linking incentive compensation to stock performance.

5. The Significance of Overall Compensation Levels

Finally, it is important to note that being at market levels does not insulate costs from review. The Commission is charged with examining the reasonableness of proposed rates; it is not charged with ensuring that all cost categories are at or below market levels. Utilities, their service areas, and their customer bases are too diverse for "market" costs to be an adequate and meaningful measure of what is prudent, reasonable, and necessary for the provision of utility service. Allowable costs will sometimes be above or below market levels.

Furthermore, in ratemaking the Commission takes final responsibility for equitably balancing the interests of ratepayers, shareholders, and the public. These interests can be affected by factors other than whether costs are at market levels, and the Commission has a duty to weigh all relevant factors in determining cost recovery issues.

As the Commission explained in Minnegasco's 1993 rate case:

> First, while total compensation amounts are important in evaluating the reasonableness of any incentive compensation plan, even a plan yielding below-market wages can be so ill-conceived or badly administered that it jeopardizes ratepayer interests. It can, for example, link such a high percentage of salary to short-term corporate financial gains that it compromises quality of service. For these reasons, the Company's low overall salary levels should not permanently shield its incentive compensation program from review.
>
> In the Matter of the Application of Minnegasco, a Division of Arkla, Inc., for Authority to Increase its Rates for Natural Gas Service in Minnesota, Docket No. G-008/GR-93-1090, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (October 24, 1994) at 12.

While market levels can be a useful starting point in examining reasonableness, they cannot function as the determining factor.

6. Conclusion

The Commission finds that linking incentive compensation payments to stock performance does not benefit ratepayers and may work to their detriment. The Commission will disallow rate recovery of the costs of that portion of the incentive compensation program, reducing test year expense by $203,405.

XIII. CAPITAL STRUCTURE AND COST OF CAPITAL

The results of the stipulated capital structure and cost of capital, together with the settled return on common equity, are set forth below:

Capital Employed	Amount ($000)	% of Total	Cost	Weighted Cost
Long-term Debt	$1,633,645	41.98%	7.09%	2.98%
Short-term Debt	$272,917	7.01%	5.74%	0.40%
Total Debt	$1,906,562	48.99%		3.38%
Preferred Equity	$200,340	5.15%	4.79%	0.25%
Net Common Equity	$1,784,826	45.86%	11.40%	5.23%
Total Equity	$1,985,166	51.01%		
Total Capital	$3,891,728	100.00%		8.85%

XIV. OVERALL FINANCIAL SUMMARIES

A. Rate Base Summary

Based on the above findings, the Commission confirms that the appropriate total average rate base for the test year is $310,298,000 as detailed in the revenue requirements stipulation and offer of partial settlement and shown below:

	(000's Omitted)
Utility Plant in Service	$560,433
Less: Accumulated Depreciation	(213,922)
Net Utility Plant in Service	346,511
C.W.I.P.	8,709
Accumulated Deferred Taxes	(45,063)
Working Capital:	
Cash	(8,309)
Materials & Supplies	2,551
Gas in Storage	13,388
Other	(7,489)
Total Average Rate Base	$310,298

B. Operating Income Statement Summary

Based on the above findings, the Commission concludes that the appropriate Minnesota jurisdictional operating income for the test year under the present rates is $19,608,000 as shown below:

Operating Revenues	(000's Omitted)
Retail Revenues	$336,584
Gross Earnings Revenues	5,158
Other Revenues	14,242
Total Revenues	$355,984
Operating Expenses	
Purchased Gas Cost	$232,582
Other Production	2,620
Transmission	1,431
Distribution	19,304
Customer Accounts	9,010
Customer Service & Information	2,955
Administrative & General	14,303
Amortizations	4,623
Depreciation	20,112
Other	1,196
Taxes Other than Income	22,097
State & Federal Income Taxes	6,336
Total Operating Expenses	$336,569
AFUDC	$193
Total Operating Income	$19,608

C. Gross Revenue Deficiency

Based on the Commission findings and conclusions. the Minnesota jurisdictional revenue deficiency for the test year is as shown below:

	(000's Omitted)
Rate Base	$310,298
Rate of Return	8.853%
Required Operating Income	$27,472
Test Year Operating Income	$19,608
Operating Income Deficiency	$7,864
Revenue Conversion Factor	1.7056
Revenue Deficiency	$13,413

The parties identified retail related revenues for the Minnesota jurisdiction of $336,584,000. Increasing revenues by $13,413,000, or 3.99%, results in total authorized Minnesota revenues of $349,997,000 for final rates for the test year.

XV. REMAINING CONTESTED RATE DESIGN ISSUES

A. Proposal to Change the Bill Format

NSP Gas proposed to change its customer bill format to separate the delivered cost of gas from the cost of distribution for all customers. A comparison of the Company's proposed bill format with the present bill format is as follows:

Present Bill Format	*Proposed Bill Format*
Customer Charge	Customer Charge
Energy Charge (Includes Conservation Cost Recovery Charge [CCRC] and base cost of gas)	Distribution Charge (Includes CCRC)
Resource Adjustment Charge (PGA) (CIP Adjustment Factor)	Resource Adjustment Charge (CIP Adjustment Factor)
	Cost of Gas (Base cost of gas) (PGA)

In support of its proposal, the Company argued that the changes would allow customers to compare gas costs and would begin to educate customers as the industry moves toward retail LDC unbundling. The Company also stated that simplifying the identification of gas costs for customers would avoid the need for complex explanations. The Company denied that the bill singled out conservation costs for customer scrutiny and noted that the annual CIP Adjustment Factor would continue to be recovered in the Resource Adjustment charge and the words "CIP" and "conservation program costs" would not be shown anywhere on the NSP Gas bill.

The Department recommended the Commission deny NSP's proposal for a new bill format. The Department argued that the Company's proposal inappropriately singled out conservation costs which could result in increased customer confusion and an unreasonably negative customer reaction to conservation programs. The Department also argued that NSP's proposal is contrary to current rules (Minnesota Rules, parts 7820.2600 and 7825.2700), since it would combine the purchase gas adjustment (PGA) and the base cost of gas into one line item on the bill. The Department noted that the Commission's rules require the PGA to be stated as a separate line item. The Department stated that a rule variance would be needed in order to implement the Company's request.

In addition, the Department argued there is no pressing need at this time for the format changes NSP is proposing. The cost of gas continues to be available to customers on request. In light of the likelihood of significant negative ratepayer reaction, NSP's proposal should be denied.

Finally, the Department argued that any proposal (such as the Company's) to modify customer bills in an attempt to educate customers in preparation for a more unbundled gas service environment should be addressed in a general forum (such as the Commission's Gas Unbundling Work Group, Docket No. G-999/CI-97-145) and implemented as an industry-wide change. In the alternative, the Department recommended that the Commission adopt the Department's proposed change.

The Administrative Law Judge supported the Department's position on this issue.

The Commission extends reasonable latitude to a utility in designing its bill format, recognizing the utility's primary responsibility for its own customer relations, especially as the industry moves toward unbundling. The Department's recommendation to wait for industry-wide recommendations from the Gas Unbundling Work Group is not accepted. During this period, experimentation with diverse approaches in billing format is quite appropriate, within reasonable bounds.

Regarding the "singling out" issue, the Commission believes that the bill format should convey basic information about the elements of a customer's bill in an objective way that will help the customer be a better informed consumer of the product at hand. It is not an appropriate purpose of a bill format either to unduly obscure or spotlight the conservation-related elements of the customers' bill. In this present case, the Commission finds that the Company's bill format treats this element with adequate even-handedness. In fact, NSP reports receiving no adverse response to CIP expenses from transport customers whose Resource Adjustment Charge is composed solely of the CIP Adjustment Factor. Based on the record established in this case, it appears that the Department's fears that the bill format will incite customers against conservation expenses are over-emphasized.

In addition, the Commission finds that the Company's announced goal in making the proposed changes (educating customers to better compare gas costs) is commendable and that the proposed changes are a reasonable move in that direction.

The Commission, of course, agrees with the Department that the Company's proposal to combine the base cost of gas with the PGA as a single line item on customers' bills as the "Cost of Gas" requires a variance from the requirement of Minn. Rules, Parts 7820.3500, item K and 7825.2700, subp. 1 that the PGA be set forth as a single line item on the bill. The Commission will grant this required variance because the standards for granting it have been met. In light of the valid educational aim of the change and other considerations noted herein, enforcement of the rule would impose an excessive burden upon the Company. Second, granting the variance would not adversely affect the public interest. Finally, granting the variance would not conflict with standards imposed by law. Minn. Rules. Part 7829.3200.

To conclude: finding no overriding policy reason to reject the Company's proposal and finding it reasonable, the Commission will accept it.

B. Three Proposals Affecting Various Aspects of CIP Cost Recovery in Minimum Flexible Rates: Subject to Minn. Stat. § 216B.164, the Flexible Tariff Statute

Minn. Stat. 216B.163, subd. 4 provides that the minimum flexible rate must recover at least the incremental cost of providing the service. CIP costs (whether recovered through the CCRC or the CIP Adjustment Factor) are incremental costs. As such, the Company's minimum flexible rate must recover them. Unlike fixed distribution system costs, CIP costs simply are not the kind of costs that may be waived or discounted, in whole or in part.

Accordingly, the Commission will reject the Company's three proposals that either waive or discount these costs in their minimum flexible rates. In light of the clear statutory requirement, NSP's and the Department's arguments regarding the comparative fairness and equity of these three proposals need not be examined as they are not relevant to the Commission's decision.

1. Proposal to Exclude CCRC From Calculation of Minimum Flexible Commodity Rates

NSP Gas proposed minimum flexible commodity rates calculated to recover incremental variable costs, but not the portion of CIP costs recovered through the Conservation Cost Recovery Charge (CCRC). The Department opposed the Company's proposal arguing that CIP costs are incremental costs which should be included in the minimum flexible rate pursuant to Minn. Stat. § 216B.163, subd. 4. The Administrative Law Judge agreed with the Department's analysis and recommended that both the average incremental operation and maintenance (O&M) costs **and** the CCRC be included in the calculation of all minimum flexible rates.

Key to the Commission's determination on this issue is its finding that CIP costs are incremental costs, as argued by the Department and recommended by the Administrative Law Judge. The Department's analysis, which the Commission adopts, is as follows:

By law, gas utilities incur greater CIP expense obligations as their sales increase. Minn. Stat. 216B.241, subd. 1a (1)(1996) requires that gas utilities spend a minimum of 0.5 percent of their annual gross operating revenues on CIP projects. As sales increase and operating revenues increase accordingly, the minimum CIP spending requirements also increase. Since additional sales increase CIP costs, these costs are an incremental cost of providing service under flexible tariffs. This conclusion is consistent with the past and present treatment of CIP costs by both the Department and NSP. In their CCOSS studies, both the Department and NSP have classified CIP costs as energy and/or capacity costs, costs which increase as energy and/or capacity requirements increase.

NSP's arguments attempting to reclassifying CIP costs as other than incremental are not persuasive:

- While not disputing that the obligation to fund CIP increases as revenues increase, NSP urged the Commission to look only at the constancy of CIP costs within the test year. NSP noted that during the test year CIP costs remain at a fixed level determined by the Department's Commissioner and do not increase as revenues increase. Consequently, NSP argued, CIP costs should not be viewed as incremental costs. The Commission declines to accept NSP's invitation to look at the nature of CIP costs from such a narrow perspective. **When CIP costs are viewed in a more reasonable context, such as the period of time that flexible tariff rates may be expected to be in effect, it is clear that the obligation to incur such costs is directly linked to the increase of sales, a well-established characteristic of incremental costs.**

- The Commission's December 20, 1991 Great Plains Order[8] cited by NSP does not support the Company's recommendation, as NSP has asserted. NSP stated that the Commission found in this Order that the term "incremental cost" in Minn. Stat. § 216B.163, subd. 4 would mean (a) the incremental fixed costs of facilities installed to serve a flex rate customer and (b) incremental variable costs to serve such a customer. The Commission did not make the asserted finding. The only flexible rates statute issue decided in the Great Plains Order was whether allowing Peoples to serve Minnesota Corn Processors at flexible rates would violate Minn. Stat. § 216B.163 by allowing one regulated utility to use flexible rates to compete for the customer of another. Order at page 3.

2. Proposal to Allow NSP to Discount the CIP Adjustment Factor in Minimum Flexible Rates Pursuant to an "Attribution Policy"

The NSP Gas petition proposed to establish an "attribution policy" in the CIP Factor Adjustment tariff page. Under this policy, if the Company needed to discount the total flexible Distribution Charge for a flexible rate customer below the fixed rate in order to compete with an alternate fuel, the annual CIP Factor Adjustment would be the first rate component to be discounted.

Although the Company presented this provision as part of the CIP Adjustment tariff page, the provision would impact rates charged under the flexible tariff and, as such, must comply with the provisions of Minn. Stat. § 216B.163.

The defect in the Company's proposal is that it proposes to "discount" (in effect, to charge certain customers a rate that does not recover) a portion of CIP costs, i.e. some or all of the CIP costs that are recovered via the CIP Adjustment Factor. As such, the Company's proposed policy conflicts with the requirement of Minn. Stat. § 216B.163 that incremental costs (all of them) must be recovered in the minimum flexible rate, as discussed and found above with reference to the CCRC issue.

Accordingly, of course, the Commission cannot accept the Administrative Law Judge's recommendation that the Commission approve the Company's proposal as reasonable. Further, in light of its finding that Minn. Stat. § 216B.163 prohibits adopting the Company's proposed policy, the Commission will not examine the Administrative Law Judge's suggestion that the Company's proposal was consistent with the Commission's ratemaking policies with regard to overall cost allocation and recovery.

3. Proposal to Exempt the Company's Negotiated Transport Services (NTS) Customers From the CCRC and the Annual CIP Adjustment Factor

NSP Gas proposed to make two changes with respect to recovery of CIP costs from its customers in the NTS class:[9] 1) to exempt NTS customers (prospectively) from the CCRC and the Annual

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[8] In the Matter of Great Plains Natural Gas Company Against Peoples Natural Gas Company and UtiliCorp United, Inc., Docket No. G-004, 011/C-91-731, ORDER DISMISSING COMPLAINT (December 20, 1991).

[9] Negotiated Transportation Service (NTS) serves customers who would otherwise physically bypass the NSP Gas distribution system. NTS customers pay deeply discounted

CIP Factor Adjustment; and 2) to preclude participation in CIP projects by any NSP Gas customer (such as NTS customers) who do not contribute to recovery of CIP costs through the CCRC or annual CIP Adjustment Factor. The Company argued that its proposal more accurately and fairly allocated CIP costs versus other non-gas components of the cost of service to specific customer classes. The Administrative Law Judge supported the Company on this issue.

The Commission again finds that the application of Minn. Stat. § 216B.241 is pivotal. As discussed previously, conservation costs are incremental costs. Therefore, despite the appeal of any arguments the Company made based on its view of what is fair and accurate, the statute controls.[10] Consistent with the Commission's findings herein that the CCRC and CIP Adjustment Factor recover incremental costs, the Company's proposal to not recover these charges from the NTS class cannot be accepted.[11]

C. NSP's Proposal to Change the Class Allocation of CIP Costs

The method traditionally approved by the Commission for allocating CIP costs in gas rate cases is an energy allocator. This method results in an across-the-board CCRC applicable to all customer sales.

Both NSP Gas and the Department had used this method (the energy allocator method) in preparing their CCOSS studies in this rate case. However, when it came to proposing allocation of costs for purposes of calculating rates, the Company proposed a different allocation method, one based on savings due to reduced capacity as well as savings due to reduced commodity

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individually negotiated rates within approved ranges. There are currently two customers in the NTS class.

[10] The Commission is sympathetic with the case presented by the Company for relief in circumstances (concern for increasing large customer options) that may not have been fully contemplated by the legislature when adopting the statutory language that shapes the Commission's CIP decisions in this Order. At the same time, the Commission does not wish to suggest that all the equities favor the Company's proposal. As the Commission has previously found: "CIP expenditures are incurred to provide system benefits and, in the long run, lower bills for all ratepayers. Therefore, all ratepayers should bear the costs of conservation projects." In the Matter of the Request of Interstate Power Company for Authority to Change Its Rates for Gas Service in Minnesota, Docket No. G-001/GR-95-406, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (February 29, 1996) at page 7. Careful examination of this complex issue within the context of emerging competition will be required.

[11] The Commission's decision on the Company's NTS proposal is also consistent with the Administrative Law Judge's findings regarding the nature of CIP costs. The Administrative Law Judge stated:

> The Department argues, and the ALJ agrees, that both the average incremental operation and maintenance (O&M) costs and the Conservation Cost Recovery Charge (CCRC) should be included in the calculation of all minimum flexible rates. [cites omitted] This means that all customers, including customers of Negotiated Transportation Service, will pay at least their incremental cost of [CIP] expenses. Administrative Law Judge Report at 13, Finding 50.

(energy) purchases.

The Company argued that its proposed capacity/energy allocator method provided a more refined cost-based allocation. The Company stated that its method took into account all the cost savings (energy **and** capacity) predicted by the models used by the Department itself when it approves a CIP project. The Company implied that the Department's opposition to the Company's capacity/energy allocator in this case is inconsistent with its support for a capacity/energy allocator in the 1991 NSP (electric) rate case.

While acknowledging that some CIP savings are capacity related, the Department countered that NSP Gas did not provide evidence that its proposed dual allocators reflected the appropriate split between capacity and energy. The Department also noted that NSP did not reference any source used in developing its model or otherwise provide details sufficient to allow the Department or the Commission to check or replicate its work. Therefore, the Department argued, NSP failed to establish a record to support its allocators or their specific proposed values. The Department also rejected the Company's claim that its allocators reflect the Department's position in other rate cases. The Department stated that it was inappropriate to rely on the Department's position in past electric rate cases unless the Company can demonstrate, which it has not in this record, that the facts of an electric case are reasonably similar to those of this gas case.

The Administrative Law Judge supported the Department's position that the Commission should adhere to the allocation methodology adopted in the last NSP Gas rate case, i.e. that conservation expenses are allocated in the CCOSS to all customer classes using an energy allocator. The Administrative Law Judge noted that this position is consistent with the Department position in other gas rate cases.

The Administrative Law Judge reasoned that NSP's proposals are unreasonable because they abandon the energy allocator methodology, and because they deviate without rational support from the allocation methodology used by both the Department and NSP in their CCOSS studies. The Administrative Law Judge stated that the Department's position best reflects the fact that all customers benefit from conservation expenses and that an energy allocator is the most reasonable allocator to use in gas rate cases. The Administrative Law Judge observed that all customers currently pay equally, based on consumption of gas. The Administrative Law Judge stated that if the Commission were to adopt either of NSP's proposed allocation methodologies, residential customers would unfairly pay a higher portion of CIP expenses.

In addition, the Administrative Law Judge found that NSP has not proven that its allocators or specific proposed values for its proposed allocators are reasonable. Absent such a showing, the Administrative Law Judge recommended that the Commission should continue its current practice in gas rate cases of allocating CIP costs to all customer classes, based on an energy allocator.
The Commission finds that the Department's and the Administrative Law Judge's positions and arguments on this issue are sound. Moreover, to the extent that the Company's proposal would fail to recover a portion of CIP costs (incremental costs) from interruptible customers, the proposal runs afoul of the reasonable ratemaking principle that rates for transportation customers must recover at least the incremental costs of providing that service. As part of its proposal that a portion of CIP costs be allocated on the basis of **capacity** savings, the Company proposed that **none** of the CIP costs so allocated (no capacity-related costs) should/would be collected from interruptible customers.[12] In other words, the Company proposed rates for interruptible customers

[12] In support of its proposal not to collect capacity reduction related CIP costs from interruptible customers, the Company advanced a strict no benefit/no pay formula. The

that failed to recover a portion of the incremental costs of providing service to those customers, i.e. CIP costs.

Accordingly, the Commission will reject the Company's proposal to change the way CIP costs are allocated in the CCOSS and adopt the Department's position to continue allocating CIP costs using an energy allocator based on class sales.

ORDER

1. Northern States Power Company's Gas Utility (NSP Gas or the Company) is entitled to increase gross annual Minnesota jurisdictional revenues by $13,413,000 in order to produce total gross annual jurisdictional operating revenues of $349,997,000.

2. Within 30 days of the date of this Order, the NSP Gas shall file with the Commission for its review and approval, and serve on all parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirement and the rate design decisions contained herein, along with the proposed effective date for the schedules, including

    a. a breakdown of Total Operating Revenues by type;

    b. schedules showing all billing determinants for the retail sale of gas, including

        i. total revenues by customer class;

        ii. total number of customers, the customer charge, and total customer charge revenue by customer class; and

        iii. for each customer class, the total number of commodity and demand related billing units, the per unit commodity and demand cost of gas, the non-gas unit margin, and the total commodity and demand-related sales revenues;

    c. revised tariff sheets incorporating the rate design decisions contained in the Order; and

    d. proposed customer notices explaining the final rates.

3. Within 30 days of the date of this Order, the Company shall file with the Commission and serve on the parties, a revised base cost of gas and supporting schedules incorporating the changes made herein, as well as the Company's automatic adjustment establishing the proper adjustment to be in effect at the time final rates become effective.

4. Within 30 days of the date of this Order, the Company shall file the calculation of the CIP CCRC based on the decisions made by the Commission.

5. Within 30 days of the date of this Order, the Company shall file schedules detailing the CIP tracker balance at the beginning of interim rates, the revenues (CCRC and CIP Adjustment Factor) and costs recorded during the period of interim rates, and the CIP tracker balance at the time final rates become effective.

Company noted that any capacity cost reductions achieved through CIP expenditures would not benefit the interruptible customers because interruptible rates are not calculated to recover any capacity costs.

6. As soon as practicable after the information becomes available, the Company shall file a report showing the calculation of the total refund, including interest calculated at the average prime rate, and the resulting adjustment of the CIP tracker balance.

7. Parties shall have 15 days to comment on the filings required in Ordering Paragraphs 1 through 6.

8. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

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